Office of Chief Counsel
Internal Revenue Service

memorandum

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date: AUG -9 2001

to: William Kennedy, Manager, Group 1282, M/S 4201PHX
Attn: Mark Nutter

from: Office of Chief Counsel, Phoenix
LMSB:NR, Area 4

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subject: [redacted]

Application of short-year tax rules

This memorandum responds to your request for assistance dated August 1, 2001. This memorandum should not be cited as precedent.

ISSUE

Whether depreciation claimed for [redacted] by [redacted] Limited Partnership is subject to the rules for short taxable years set forth in Rev. Proc. 89-15, 1989-1 C.B. 816.

CONCLUSION

Because [redacted] Limited Partnership is a disregarded entity for federal tax purposes, its claimed depreciation for [redacted] is not subject to the rules for short taxable years set forth in the revenue procedure.

FACTS

[redacted] ([redacted]) is a wholly-owned subsidiary of the taxpayer. [redacted] was the sole member of [redacted], LLC (LLC), a single member limited liability corporation. In [redacted], [redacted] and LLC formed [redacted] ([redacted]). During [redacted], [redacted] placed a substantial amount of assets in Service. [redacted] issued Forms K-1 for [redacted] to its purported partners, and filed a Form 1065, which included amounts for depreciation of the items placed in service during [redacted].

You are now proposing to subject [redacted]'s claimed depreciation for [redacted] to the short-year rules set forth in Rev. Proc. 89-15, 1989-1 C.B. 816. The details of such rules are not critical to an analysis of the present issue; the important fact is that application of such rules in the present case would significantly reduce allowable depreciation from that claimed by the taxpayer. The taxpayer has responded to your proposed adjustment by asserting that [redacted] is not really a partnership, but instead is an entity disregarded for federal tax purposes. According to the taxpayer, the partnership return was filed in error, and the activities of [redacted] should have been reported on the taxpayer's consolidated return. Under such a scenario, the assets at issue would not have been placed in service in a short taxable year, and the revenue procedure would therefore not apply. You have requested our opinion on the taxpayer's response to your proposed adjustment.

DISCUSSION

The determining factor as to whether [redacted] is subject to the procedures for short taxable years is whether or not it constitutes a separate entity for federal tax purposes. If so, then its creation in [redacted] caused its [redacted] taxable period to be a short taxable year. If it is not a separate entity for federal tax purposes, then it should be disregarded for federal tax purposes; as the taxable year for its single member ([redacted]) was not a short taxable year, disregarding [redacted] would mean that the short-year rules do not apply.

In that regard, you recognize that as of January 1, 1997, the classification rules determining the nature of an entity for tax purposes changed radically. Instead of the long-standing facts and circumstances test, the so-called "check the box" regulations now provide the standards under which an entity's tax status is to be determined.

Treas. Reg. § 301.7701-2(b) provides that certain entities are automatically corporations for federal tax purposes. These include, for example, entities organized under a State incorporation statute and business entities that are taxable as corporations under a Code provision other than § 7701(a)(3).

Pursuant to Treas. Reg. § 301.7701-3(a), an "eligible entity," i.e., a business entity that is not automatically a corporation under enumerated portions of Treas. Reg. § 7701-2(b), can elect how it wishes to be classified for federal tax purposes. An eligible entity with more than one member can elect

to be classified either as an association (and thus as a corporation under Treas. Reg. § 301.7701-2(b)(2)) or as a partnership. If an eligible entity with at least two members fails to make an election, it is treated for federal tax purposes as a partnership. Treas. Reg. § 301.7701-3(b)(i).

An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Treas. Reg. § 301.7701-3(a). If an eligible entity with a single owner fails to make an election, it is disregarded as a separate entity for federal tax purposes. Treas. Reg. § 301.7701-3(b)(ii). The activities of disregarded entities are treated in the same manner as those of a division of its owner, and its assets will be treated as those of the owner.

The elections discussed above are made on Form 8832, Entity Classification Election. Treas. Reg. § 301.7701-3(c)(1) provides, "An election will not be accepted unless all of the information required by the form and instructions... is provided on Form 8832." This form need only be filed if an eligible entity chooses to be classified as other than the default classification or when an eligible entity chooses to change its classification. Treas. Reg. § 301.7701-3(c)(1).

In the present case, [redacted] and LLC are the two partners in [redacted], which has not filed a Form 8832. [redacted] is a corporation under the provisions of Treas. Reg. § 301.7701-2(b)(1), as it is organized under a State incorporation statute. Since the LLC has a single member and has never filed a Form 8832, it is by default disregarded for federal tax purposes under Treas. Reg. § 301.7701-3(b)(ii). It is therefore treated as a division of [redacted], the only other partner.

This leads to the question of whether disregarding LLC for federal tax purposes causes it to be disregarded when determining the number of [redacted]'s owners. If LLC is considered an owner of [redacted], then [redacted] is by default a partnership under the check the box regulations; if LLC is disregarded for the purpose of determining the number of owners, then [redacted] is by default disregarded for tax purposes. The taxpayer has suggested that in a private letter ruling (PLR 200107018), the Service has indicated its position to be that an entity disregarded for tax purposes will be disregarded when determining the classification of entities in which it has an interest. As you know, private letter rulings are not precedential; they nonetheless often reveal current Service thought on an issue. In this letter ruling, the factual situation is much more complex than your

situation, but does include the same important elements: an entity involved in a partnership with a wholly-owned eligible entity which has failed to make an election. In the letter ruling, the determination that one of two partners was a disregarded entity resulted in the determination that the partnership, which had likewise failed to file a Form 8832, was to be disregarded for federal tax purposes. We are advised by national office personnel that this letter ruling correctly sets forth Service position regarding this issue. If an entity is disregarded for federal tax purposes, as is the LLC in the present case, then it is disregarded in determining the classification of any other entity, such as [redacted]. This would leave [redacted] with only one "partner." Under the relevant regulations, [redacted] could only choose to be an association or disregarded for federal tax purposes. Because it did not file a Form 8832, it is by default a disregarded entity.

You have asked whether the filing by [redacted] of a partnership might constitute an election under the check the box regulations to be classified as a partnership. As mentioned above, Treas. Reg. § 301.7701-3(c)(1)(i) specifies that an election will not be accepted unless all the required information "is provided on Form 8832." Even if, however, an election could be made in other manners, the only options open to [redacted] were to be treated as an association or to be disregarded for federal tax purposes. [redacted] could not elect to be a partnership, and therefore a partnership return cannot be deemed a valid election to be treated as a partnership. For the above reasons, [redacted] must be disregarded for federal tax purposes. [redacted] therefore did not conduct its activities in [redacted] in a short taxable year, and the short-year rules of Rev. Proc. 89-15 do not apply.

Please be advised that we consider the statements of law expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow the Division Counsel (Large and Mid-Size Business) an opportunity to comment. If you have any questions regarding the above, please contact the undersigned at (602) 207-8052.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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Area Counsel
(Natural Resources)

By:_____
JOHN W. DUNCAN
Attorney

CC: Division Counsel (Large and Mid-Size Business)